August 10, 2016

Practice Group(s):

Investment Management, Hedge Funds and Alternative Investments

Retail Distribution of Credit Linked Notes to Be Banned in Germany

By Dr. Hilger von Livonius, Dr. Philipp Riedl and Michael Harris

The German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) plans to issue a ban on the retail distribution of credit linked notes in Germany. For this purpose, on July 28, 2016, BaFin published a draft general ruling (*Allgemeinverfügung*) by which the distribution of structured notes (certificates) that are linked to credit risks (i.e., credit linked notes) will be significantly restricted (GZ: VBS 7-Wp 5427-2016/0019).

In this draft, BaFin defines credit linked notes as notes “that offer a means of investing in a borrower’s credit risk. The amount of interest and the capital repayment are dependent on the borrower’s creditworthiness. As long as the borrower does not experience a credit event, the investor will receive interest payments and, upon maturity of the notes, their nominal value. If a credit event does occur, however, the note is repaid early. In this case, interest payments cease, and the amount repaid may be significantly below the notes’ nominal value.” BaFin further assumes that credit linked notes normally represent a bond that is combined with an embedded credit derivative (credit default swap) and that the investor in such notes provides some form of protection (coverage) against the default risk of the debtor of the underlying claim.

The draft ruling sets out a ban on any future marketing, distribution or sale of credit linked notes to “retail clients” as defined in § 31a (a) of the German Securities Trading Act (WpHG), which is equivalent to the definition under MiFID. The ban is addressed to issuers, companies, and persons who market, distribute or sell credit linked notes to retail clients. The results of a study on the sale of credit linked notes to retail investors in Germany that was conducted in the first half of 2016 prompted BaFin to conclude that credit linked notes pose significant risks for investors (particularly in view of the products’ high degree of complexity). BaFin takes the view that retail investors are unable to assess the probability of interest and principal payment or whether adequate compensation for the additional credit risk is provided by the product conditions. BaFin also sees a conflict of interest since the issuers produce the products, maintain business relationships with the companies whose credit risks underlie their products, and may act as lenders themselves. Moreover, calling the products bonds (Anleihen) is regarded as being misleading due to the fact that the role of the investor is not that of a traditional (bond) lender, but rather it is similar to that of a seller of protection against the risk of a credit event with respect to the referenced entity.

The legal basis for the ruling is § 4b (1) no. 1 WpHG, a new provision introduced by the German Retail Investor Protection Act (*Kleinanlegerschutzgesetz*) in July 2015 anticipating the implementation of the product intervention powers set out in Regulation (EU) No. 600/2014 of the European Parliament and of the Council of May 15, 2014 on markets in financial instruments and amending Regulation No. 684/2012 (MiFIR).

The draft ruling is open for comments from the public until September 2, 2016.

Retail Distribution of Credit Linked Notes to Be Banned in Germany

Authors:

Dr. Hilger von Livonius
hilger.livonius@klgates.com
T +49.89.321.215.330

Dr. Philipp Riedl
philipp.riedl@klgates.com
T +49.89.321.215.335

Michael Harris
michael.harris@klgates.com
T +49.89.321.215.336